Exercise walk-through

Fiscal policy ▪ 5.2

eXercise

You must be able to

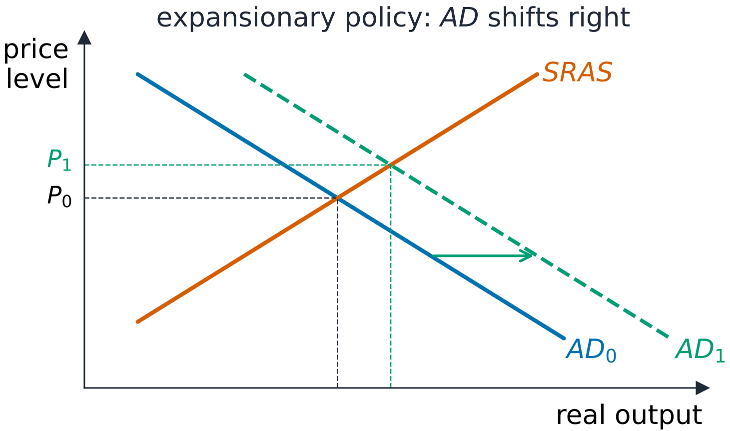
- define fiscal policy, budget deficit and surplus
- classify taxes and explain expansionary vs contractionary policy
- analyse the effectiveness of fiscal policy (including crowding out)

Method — Using government spending and tax

- **Budget deficit 预算赤字**: spending > tax (must borrow → **national debt 国债**). **Surplus:** tax > spending.
- **Progressive tax 累进税**: rate rises with income; **regressive 累退税**: rate falls with income.
- **Expansionary 扩张性** (more G / lower T) → AD right (fights recession); **contractionary** → AD left (fights inflation).
- **Crowding out 挤出效应**: heavy government borrowing raises interest rates → less private investment.

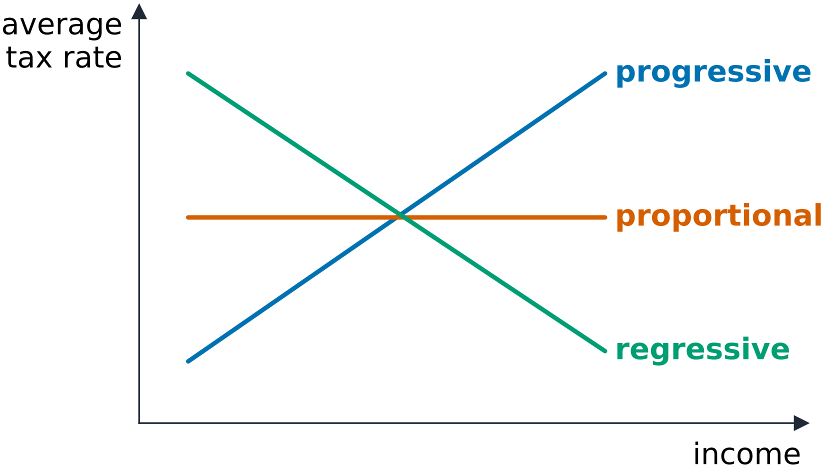
Answer shapes: an **Explain [up to 8]** answer may use an AD–AS diagram (AO3); **Discuss [12]** adds a judgement (AO4).

Method — Using government spending and tax



Expansionary fiscal policy shifts AD right, raising output and the price level

Method — Using government spending and tax



Practice 2.1 ▪ 2 marks

Define the term *budget deficit*.

Solution 2.1

Method: Using government spending and tax

Worked steps

when government spending is greater than tax revenue, so the government must borrow (2 for a clear definition; 1 for a partial idea).

Practice 2.2 ▪ 2 marks

State the difference between a *progressive* and a *regressive* tax.

Solution 2.2

Method: Using government spending and tax

Worked steps

a progressive tax takes a rising percentage of income as income rises; a regressive tax takes a falling percentage as income rises (2 for a clear difference; 1 for a partial idea).

Practice 2.3 ▪ 2 marks

State two tools of expansionary fiscal policy.

Solution 2.3

Method: Using government spending and tax

Worked steps

any two of: cut taxes; raise government spending $(1 + 1)$.

Exam-style 3.1 ▪ 1 mark

Expansionary fiscal policy involves:

- **A** higher taxes and lower government spending
- **B** lower taxes and higher government spending
- **C** a higher interest rate
- **D** selling state-owned firms

Solution 3.1

Method: Using government spending and tax

A higher taxes and lower government spending

B lower taxes and higher government spending ✓

C a higher interest rate

D selling state-owned firms

Worked steps

B. Expansionary fiscal policy cuts taxes and raises spending.

Exam-style 3.2 ▪ 8 marks

Using an AD–AS diagram, explain how expansionary fiscal policy could reduce unemployment.

Solution 3.2

Method: Using government spending and tax

Worked steps

[8] AO1 1 + **AO3 diagram up to 4** (AD shifts right, output rises) + AO2/AO3 up to 3 — lower taxes raise disposable income and consumption, and higher G adds to spending → AD shifts right → firms produce more to meet demand → they hire more workers → cyclical unemployment falls.

Exam-style 3.3 ▪ 12 marks

Discuss whether fiscal policy is an effective way to reduce unemployment.

Solution 3.3

Method: Using government spending and tax

Worked steps

[12] AO1/AO2/AO3 up to 8 + AO4 up to 4. **For:** it directly raises AD and can target spending (e.g. infrastructure) to create jobs. **Against:** time lags, a rising deficit and debt, crowding out, and it cannot fix *structural* unemployment (a skills mismatch). Judgement: fiscal policy works well against cyclical unemployment in a recession, but is weaker against structural unemployment and is limited by the state of public finances.